

## Message Text

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20

ACTION EA-10

INFO OCT-01 EUR-12 ISO-00 SP-02 AID-05 EB-07 NSC-05

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FM AMCONSUL HONG KONG

TO SECSTATE WASHDC 4770

INFO AMEMBASSY LONDON

AMEMBASSY SEOUL

AMEMBASSY SINGAPORE

AMEMBASSY TAIPEI

AMEMBASSY TOKYO

USLO PEKING

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PASS TREASURY AND FEDERAL RESERVE BANK

E.O. 11652: N/A

TAGS: EFIN, HK

SUBJECT: HONG KONG: STABILIZATION, STAGNATION AND DEFICIT  
FINANCING

REF: HONG KONG 11231, 10/11/74

1. INTRODUCTION AND SUMMARY - THE WORLD RECESSION HIT HONG KONG  
HEARD IN THE THIRD QUARTER OF 1974. FORTUNATELY, PRICES ALSO BEGAN  
TO STABILIZE AT THE SAME TIME. AS A CONSEQUENCE OF RECESSION,  
INFLATION AND AN AMBITIOUS PUBLIC WORKS PLAN, THERE WAS A BUDGET  
DEFICIT IN FY 1974, THE SECOND SINCE 1946. ANOTHER IS PLANNED FOR  
THIS FISCAL YEAR. THE GOVERNMENT'S WILLINGNESS TO ACCEPT TWO AND  
PROBABLY THREE CONSECUTIVE BUDGET DEFICITS IS AN INDICATION HOW  
CONSTRAINED ECONOMIC POLICY HAS BECOME BY ITS SOCIAL OBJECTIVES.

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THE OUTLOOK FOR THIS YEAR IS FOR SLIGHTLY DECLINING ECONOMIC

ACTIVITY, AND PRICE STABILITY. GDP COULD BE DOWN 2-4 PERCENT COMPARED TO 1974. A FEW SCATTERED INDICATIONS SUGGEST THAT THE FOURTH QUARTER MAY SEE AN EXPORT UPTURN AND THAT 1976 SHOULD BE A BETTER YEAR. HONG KONG EXPORTS CONTINUE THEIR SHIFT AWAY FROM THE AMERICAN MARKET WHILE THE U.S. SHARE OF HK IMPORTS IS STILL RISING. A PROPOSED NEW DIVIDEND TAX COULD AFFECT THE ATTRACTIVENESS OF THE COLONY AS A LOCATION FOR CORPORATE REGIONAL HEADQUARTERS. (END SUMMARY).

2. GROWTH PRACTICALLY CEASED IN 1974. ESTIMATED GDP, IN CONSTANT PRICES, ROSE 1.5 PERCENT COMPARED TO ABOUT 9 PERCENT IN 1973 AND THE REVISED ESTIMATES WILL PROBABLY BE ZERO. THE KEY ELEMENT IS, OF COURSE, THE DECLINE IN EXPORT VOLUME, 7 PERCENT FOR THE YEAR. IN CONTRAST, EXPORTS IN THE FIRST SIX MONTHS WERE UP FOUR PERCENT ON THE COMPARABLE PERIOD OF 1973. VOLUME FELL STEEPLY FROM THE THIRD QUARTER ON. MANUFACTURING, PRIVATE CONSTRUCTION AND TOURISM ALL APPEAR TO BE SLIGHTLY BELOW 1973 LEVELS FOR THE YEAR AS A WHOLE IN REAL TERMS. ONLY THE PUBLIC SECTOR CONTINUES TO INCREASE. IT IS NOW EQUAL TO 20 PERCENT OF GDP COMPARED TO AN AVERAGE OF 15 PERCENT IN THE NINETEEN SIXTIES. PER CAPITA CONSUMPTION HAS FALLEN, PROBABLY IN THE ORDER OF 5 PERCENT. INVESTMENT, OVERALL, IS PROBABLY THE SAME AS IN 1973.

3. INFLATION AND CREDIT - INFLATION HAS LARGELY DISAPPEARED. IMPORT PRICES HAVE LEVELED OFF AND THE DECLINE IN THAI RICE PRICES HAS HAD A SALUTARY EFFECT ON LOCAL FOOD PRICES. FAIRLY TIGHT LIQUIDITY, HIGH INTEREST RATES IN THE FIRST NINE MONTHS AND DECLINING ACTIVITY KEEPS LOCAL WAGES AND PRICES UNDER CONTROL. THE FOLLOWING TABLE INDICATES THE PERCENTAGE RATES OF INCREASE OVER THE PRECEDING TWELVE MONTHS:

	(1)	(2)	(3)	(4)
	MONEY	BANK//	CONSUMER	
	SUPPLY(M3)	CREDIT	PRICES	WAGE RATES/
DATE				
12/72	29	48	9	11
12/73	7	30	19	11
6:74	16	N.A.	15	N.A.
12/74	17	9	10	3
1/75	15	N.A.	3	N.A.
2/75	16	N.A.	3	N.A.

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/ YEAR ENDING IN SEPTEMBER

// DOMESTIC, AVAILABLE ONLY AT YEAR END

4. THE CURRENT TREND OF PRICE INCREASE IS PROBABLY ABOUT 3-5 PERCENT AND WAGE RATES ARE NOT LIKELY TO BE INCREASING AT ALL, GIVEN THE PRESENT RATE OF UNEMPLOYMENT WHICH MAY BE ABOUT 10 PERCENT. CAUTIOUS BANK LENDING POLICY HAS BEEN ONE OF THE POWERFUL FORCES EFFECTING BOTH INFLATION AND THE LEVEL OF ECONOMIC

ACTIVITY. THE BANKS, THANKS TO THIS ATTITUDE, AND THE BALANCE-OF-PAYMENTS SURPLUS IN THE PERIOD OCTOBER-FEBRUARY, HAVE RESTORED THEIR LIQUIDITY POSITION AND ARE PREPARED TO LEND, ONCE THERE ARE INDICATIONS THAT EXPORTS ARE TURNING UP. IN THE ABSENCE OF A CENTRAL BANK, THIS ATTITUDE IS MAINLY A REFLECTION OF THE CONSERVATIVE APPROACH OF THE HONG KONG AND SHANGHAI BANK WHICH HAS A PREDOMINANT INFLUENCE ON LOCAL LENDING POLICY THROUGH THE SHEER SIZE OF ITS OWN PORTFOLIO AND ITS LENDER-OF-LAST-RESORT RELATIONSHIP TO MANY BANKS.

5. TRADE AND BALANCE-OF-PAYMENTS- WHILE THE TRADE DEFICIT WAS LARGER IN 1974, HK\$4.1 BILLION COMPARED TO \$3 BILLION THE YEAR BEFORE, 70 PERCENT OF THE DEFICIT TOOK PLACE IN THE FIRST SIX MONTHS OF THE YEAR. IN THE PAST SIX MONTHS, THE DEFICIT HAS BEEN RUNNING AT AN ANNUAL RATE OF HK\$2.8 BILLION. USING THE CONVENTIONAL RULE OF THUMB, THAT HONG KONG HAS AN INVISIBLE SURPLUS IN THE SECTORS OF TOURISM, PORT AND FINANCIAL SERVICES, ETC., OF HK\$2 BILLION, WOULD LEAVE A CURRENT ACCOUNT DEFICIT OF HK\$800 MILLION. THIS WOULD BE FAIRLY EASILY COVERED BY FOREIGN SUPPLIERS CREDITS AND INVESTMENTS. THIS SHIFT FROM A LARGE DEFICIT AND HIGH RATE OF INFLATION TO A BASIC BALANCE EQUILIBRIUM OR POSSIBLY SURPLUS AND LITTLE OR NO INFLATION IS ONE OF THE MAJOR REASONS FOR THE UNDERLYING STRENGTH OF THE HONG KONG DOLLAR. SINCE IT FLOATED ON NOVEMBER 25 IT HAS REMAINED MORE APPRECIATED THAN ITS OLD PARITY.

6. IMPORTS AND DOMESTIC EXPORTS (EXCLUDING RE-EXPORTS) ROSE 18 PERCENT IN NOMINAL VALUE. IMPORTS TOTALLED US\$6.8 BILLION WHILE EXPORTS REACHED US\$4.5 BILLION AND RE-EXPORTS \$1.4 BILLION, LEAVING A TRADE DEFICIT OF \$800 MILLION. THE HKG DEFLATES THESE FIGURES WITH UNIT VALUE INDEXES, REVEALING THAT EXPORT VOLUME FELL 7 PERCENT AND IMPORTS BY 10 PERCENT. EVERY IMPORTANT CATEGORY OF EXPORTS DECLINED EXCEPT ELECTRONIC COMPONENTS AND WATCHES AND LIMITED OFFICIAL USE

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CLOCKS. SHIPMENTS TO THE U.K. AND U.S. WERE PARTICULARLY HARD HIT WHILE THOSE TO AUSTRALIA, (UNTIL LATE IN THE YEAR) BRIGHTENED AN OTHERWISE POOR PERFORMANCE. ALTHOUGH THE VOLUME OF TRADE TO

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ACTION EA-10

INFO OCT-01 EUR-12 ISO-00 SP-02 AID-05 EB-07 NSC-05

CIEP-01 TRSE-00 SS-15 STR-04 OMB-01 CEA-01 CIAE-00

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PASS TREASURY AND FEDERAL RESERVE BANK

GERMANY LEVELED OFF IT LOOKS AS IF IT WILL SURPASS THE U.K. THIS YEAR AS THE COLONY'S SECOND LARGEST EXPORT MARKET.

7. HONG KONG EXPORTS AGAIN LOST GROUND IN THE U.S. MARKET WITH THE PERCENTAGE OF DOMESTIC EXPORTS GOING THERE FALLING FROM 35 TO 32. VOLUME HAS NOW FALLEN ABOUT 10 PERCENT SINCE 1971. ON THE IMPORT SIDE, THE U.S. SHARE INCREASED FROM 12.8 PERCENT TO 13.5 PERCENT AND VOLUME FELL ONLY 4 PERCENT OR LESS THAN HALF OF THAT OF IMPORTS AS A WHOLE. SINCE 1971, THE VOLUME OF U.S. IMPORTS HAS RISEN 21 PERCENT. HOWEVER, SHIPMENTS FROM THE U.S. ARE STILL ONLY TWO THIRDS OF HONG KONG EXPORTS TO THE U.S. SO THAT OUR BILATERAL DEFICIT HAS ONLY FALLEN US\$50 MILLION.

8. ALL CATEGORIES OF IMPORTS DECLINED EXCEPT FUEL (PLUS 2 PERCENT) AND CAPITAL GOODS (PLUS 6). THIS LAST ITEM IS A REFLECTION OF LIMITED OFFICIAL USE

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EARLIER EXPANSION PLANS IN 1973. THE UNIT VALUE OF FUEL PRICES ROSE 2.75 TIMES COMPARED TO THE 3.5 RATIO IN MOST COUNTRIES BECAUSE HONG KONG IMPORTS ONLY REFINED PRODUCTS. HIGHER OIL PRICES COST AN ADDITIONAL US\$250 MILLION IN 1974. RAW MATERIALS FELL 13 PERCENT, AS A CONSEQUENCE THE EXPORT DECLINE WHILE CONSUMER GOODS (-12) AND FOODSTUFFS (-10) REFLECT MAINLY THE FALL IN CONSUMPTION OF

THOSE DEPENDENT ON WAGES AND SMALL BUSINESS PROFITS.

9. THE BUDGET DEFICIT - THE TRADITIONAL ASSUMPTIONS OF BUDGET MAKING IN HONG KONG ARE:

- A) EXPENDITURES CAN BE CUT FAIRLY FREELY WHEN NECESSARY,
- B) REVENUE YIELDS, ALWAYS UNDERESTIMATED, RISE SIGNIFICANTLY EVERY YEAR AND,
- C) TAX RATES, PARTICULARLY THOSE EFFECTING MOST BUSINESS ENTERPRISES, SHOULD BE KEPT AS STABLE AS POSSIBLE.

THE RESULT HAS ALMOST ALWAYS BEEN A SURPLUS. BUT IN THE LAST FISCAL YEAR (ENDING 3/31/75) AND THIS ONE, THE FIRST TWO ASSUMPTIONS ARE BECOMING INCREASINGLY UNREALISTIC. THE SOCIAL GOALS, SET BY THE GOVERNMENT REQUIRE CONTINUING AND RISING EXPENDITURES ON EDUCATION, HEALTH AND HOUSING, REGARDLESS OF THE FISCAL SITUATION. NO ECONOMIC GROWTH LAST YEAR OR THIS HAS ENDED THE RISE OF REVENUE FOR THIS FISCAL YEAR. ON THE OTHER HAND, THE TRADITIONAL BELIEF IN STABLE TAX RATES TO ENCOURAGE INVESTMENT, WAS REINFORCED THIS YEAR BY THE FEAR THAT LARGE TAX RATE INCREASES TO COVER UNAVOIDABLE EXPENDITURES RISES WOULD PUSH UP AN ALREADY HIGH RATE OF UNEMPLOYMENT.

10. THE RESULT IS THE FIRST BUDGETED DEFICIT IN HONG KONG'S POSTWAR HISTORY. IN FISCAL YEAR 1974-1975, THE GOVERNMENT BUDGETED FOR A BALANCE. UNCHARACTERISTICALLY, REVENUE WAS NOT UNDERESTIMATED BUT EXPENDITURES WERE. THE CONSEQUENCE WAS AN ESTIMATED DEFICIT OF HK\$400-500 MILLION, ABOUT 6 PERCENT OF EXPENDITURE. THIS YEAR IT IS PROJECTING A DEFICIT OF THE SAME MAGNITUDE. ALTHOUGH, IT HAS MANAGED TO REDUCE THE EXPENDITURE RISE TO SEVEN PERCENT, REVENUE YIELDS IN THE ABSENCE OF HIGHER TAX RATES OR NEW TAXES ARE NOT EXPECTED TO RISE AT ALL. IN ORDER TO PREVENT THE DEFICIT FROM RISING, IT IS PROPOSING (WHICH IS ALMOST TANTAMOUNT TO PUTTING INTO EFFECT) NEW REVENUE MEASURES YIELDING A HALF-A-BILLION HONG KONG DOLLARS.

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11. THE TAX INCREASE IN ROUND NUMBERS ARE:

- A) 100 MILLION FOR AN INCREASE IN THE CORPORATE INCOME RATE FROM 15 PERCENT TO 16.5 PERCENT (THE FIRST INCREASE IN INCOME TAXES SINCE 1966),
- B) 200 MILLION FROM HIGHER LEVIES ON BETTING, TOBACCO, LIQUOR, ETC., AND
- C) 300 MILLION FROM HIGHER FEES OF EVERY KIND.

THE REACTION OF THE PUBLIC, IN VIEW OF THE GOVERNMENT'S FISCAL REPUTATION, WAS A SIGH OF RELIEF THAT THE BITE WAS SO SMALL AND SO DIFFUSE.

12. FINANCING THE DEFICIT- SINCE THE FINANCIAL SECRETARY IS DETERMINED NOT TO PLAN FOR A FURTHER RUNDOWN OF RESERVES, THE

HONG KONG GOVERNMENT, FOR THE FIRST TIME SINCE 1946, IS ACTIVELY EXPLORING WAYS OF BORROWING. ALTHOUGH ISSUES OF LOCAL TREASURY BILLS HAVE BEEN MENTIONED AND MAY ACTUALLY BE SOLD IN SMALL QUANTITIES, PRIMARY RELIANCE WILL BE ON FOREIGN BORROWING. THE PROBABLE FORM FOR MOST OF IT IN THIS FISCAL YEAR WILL BE A PLACEMENT OF MEDIUM-TERM BONDS (5-7 YEARS) IN THE EURODOLLAR MARKET. THE GOVERNMENT ALSO EXPECTS TO SIGN A \$20 MILLION ADB LOAN FOR SEWAGE DEVELOPMENT IN THE SHATIN NEW TOWN PROJECT BUT VERY LITTLE OF IT WILL BE DISBURSED DURING THIS FISCAL YEAR.

13. OUTLOOK- THE FINANCIAL SECRETARY IS PROJECTING GAPS OF HK\$500 MILLION PER YEAR FOR THE NEXT TWO FISCAL YEARS, AFTER TAKING INTO ACCOUNT EXPENDITURES FOR CURRENT PURPOSES, THE INVESTMENT PROGRAM AND THE YIELD OF THE TAX STRUCTURE, BASED ON A FIVE PERCENT GDP GROWTH IN 1976 AND A SEVEN PERCENT GROWTH IN 1977. THESE GAPS MUST BE FILLED EITHER BY HIGHER TAX RATES, IMPROVED COVERAGE OF EXISTING LEVIES OR MORE BORROWING. THE POLICY BIAS IS TOWARD IMPROVED YIELDS FROM EXISTING RATES. IN THIS RESPECT, THE INCREASE IN THE CORPORATE PROFIT TAX RATE IS AN INTERIM MEASURE WHICH WILL BE REPLACED BY A TAX ON DIVIDENDS NEXT YEAR.

14. THE DIVIDENT TAX IS AN INNOVATION FOR HONG KONG AND ONE WHICH U.S TAX EXPERTS, RESIDENT IN THE COLONY, LOOK UPON AS THE THIN WEDGE OF NEW MEASURES DESIGNED TO TAP INCOME DERIVED FROM CORPORATE AFFILIATES DOING BUSINESS IN OTHER COUNTRIES. HONG KONG'S CURRENT ATTRACTION FOR REGIONAL HEADQUARTERS IS THAT FOREIGN SOURCE INCOME IS NOT SUBJECT TO TAXATION. HOWEVER, IF DIVIDENDS, LIMITED OFFICIAL USE

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PER SE, ARE TAXED THEN OFFSHORE INCOME WILL BE INCLUDED IN THE NET. LAST YEAR MEASURES WITH THE SAME EFFECT WERE PROPOSED BUT DIED IN LEGCO DISCUSSION. THIS POLICY, WOULD EFFECT NOT ONLY U.S. AND OTHER FOREIGN COROPRATIONS BUT THE MANY LOCAL COMPANIES HAVING INVESTMENTS IN SOUTHEASTASIA AND THE PACIFIC.

15. APART FROM THE CUSHIONING EFFECT OF INCREASED PUBLIC SECTOR SPENDING THIS YEAR, ALL OTHER AREAS OF ACTIVITIES REFLECT THE DEPRESSED LEVELS OF LATE LAST YEAR. ALTHOUGH THE OFFICIAL FORECAST IS FOR NO GROWTH, THE MOST LIKELY PROSPECT IS FOR A DECLINE IN REAL GDP. GDP COULD BE DOWN 2-4 PERCENT COMPARED TO 1974. THERE HAS BEEN SOME RESUMPTION IN ORDERS PARTICULARLY FOR TEXTILES AND GARMENTS AND IN ELECTRONICS FOR DELIVERY LATE THIS YEAR. EXPORTERS, HAVING RUN OFF THEIR HIGH PRICED STOCK OF RAW MATERIALS, ARE NOW IN A BETTER POSITION TO QUOTE MORE COMPETITIVE PRICES. IF , AS SEEMS LIKELY, THE EXCHANGE RATE REMAINS AROUND HK\$5/US\$1, THEN THE COLONY SHOULD BENEFIT AS IN THE PAST FROM THE IMPROVEMENT OVERSEAS BUT PROBABLY NOT AS MUCH AS KOREA AND TAIWAN. IT ALL DEPENDS ON THE TIMING OF THE UPTURN IN THE U.S. AND GERMANY AND HOW MUCH OF THIAI IS OFFSET BY THE

FURTHER DECLINE IN U.K. PURCHASES.

16. COMMENT-- THE FINANCIAL SECRETARY IS FIGHTING A REAR GUARD ACTION AGAINST THE LARGER SCALE USE OF THE BUDGET TO ACCOMPLISH SOCIAL OBJECTIVES IN THE COLONY. HE HAS SHAVED AS MUCH AS HE DARED AND SET UP A VARIETY OF SELF-IMPOSED AND IMPORTANT SOUNDING RULES LIMITING TAXATION AND BORROWING ALL WITH THE PURPOSE OF MOVING BACK TOWARD THE RULE OF A BALANCED BUDGET. THIS IS A SENSIBLE POLICY FOR AN ECONOMY WHERE INTERNATIONAL ACTIVITIES PREDOMINATE AND MAKE LOCAL COUNTER CYCLICAL POLICY IMPRACTICAL. GIVEN THE FACT THAT HE HAS PROBABLY OVERESTIMATED THE FUTURE RATE OF ECONOMIC GROWTH AND UNDERESTIMATED EXPENDITURES, HE WILL HAVE TO LIVE WITH A REGULAR DEFICIT AND THE PROBABILITY OF HIGHER TAX RATES AND BORROWING, AS A NORMAL PROCEDURE, WILL BE MUCH GREATER THAN IN THE PAST.  
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